

## Risk on

16 July 2009

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### Macroeconomic Update: Upside risks

- Sharp improvements in surveyed business conditions and confidence are an encouraging sign that GDP growth remained positive in Q2 and that the recent improvement in sectors benefiting from policy stimulus may be broadening to other industries.
- Despite further “greenshoots” in the activity data, survey measures of inflationary pressures remain subdued. Next week’s official CPI figures are expected to show a gradual deceleration in inflation.

### Interest Rate Markets: The correction falters

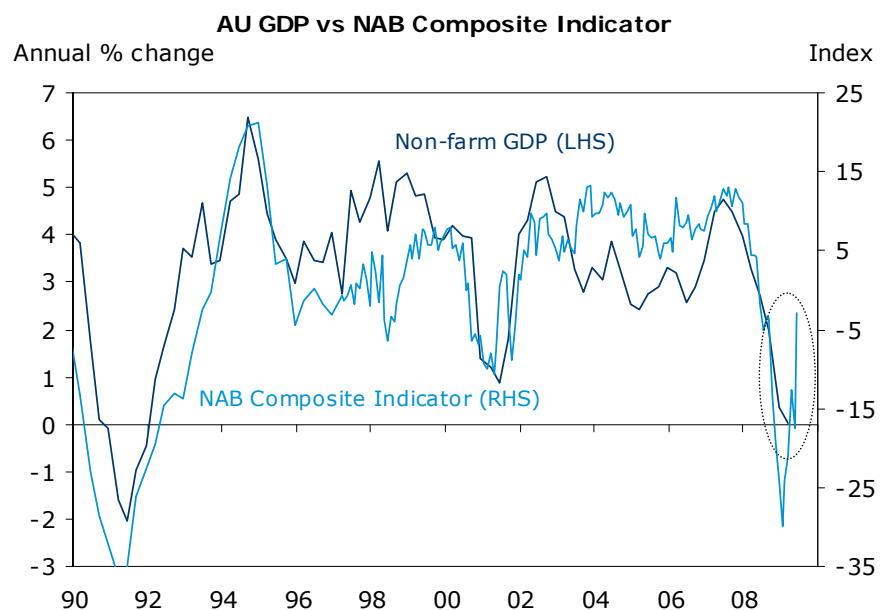
- The recent fall in market rates was limited and short-lived. Strong domestic data, unexpected strong inflation data and possible signs that extra-ordinary policy measures are being unwound have put a floor under market rates. Risk is now for a sustained move higher.
- Recent data has highlighted the extent to which Australia is outperforming. As rate cut expectations have been unwound, there has been a significant flattening of the domestic yield curve over the past 5 weeks.

### FX: Risk on – AUD/USD flirting with 0.80

- AUD remains stuck in a broad trading range against most major currency crosses. This is in line with other financial indicators, with equity and commodity markets also maintaining recent broad trading ranges.
- For now, expect the US earnings season to continue to dominate direction, both for short-term moves and likely direction for the rest of Q3.

### Chart of the week

**Figure 1: Business survey highlights upside risks to Australian GDP**



Sources: NAB, ABS

## Macroeconomic Update: Upside risks

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### Upbeat businesses highlight upside economic risks

This week’s NAB Monthly Business Survey showed a stark improvement in surveyed business conditions, business confidence and the outlook for employment. Business confidence was positive for the first time since December 2007 and has improved a massive 36 points from its low of -32 recorded in January. Business conditions rose by 12 points to -2, the highest outcome in a year, driven by improvements in profitability, trading conditions, forward orders, employment, export sales and stocks.

This is an encouraging sign that quarterly GDP growth remained positive in Q2 (see Chart of the Week on page 1). It also provides some tentative evidence that the recent improvement in economic activity is broadening across industries rather than simply being concentrated in areas receiving significant support from cash handouts (ie. retail). While retail trade is the only industry recording outright positive conditions and has unambiguously benefited from policy support, mining conditions have improved to 0 (in trend terms) and there has been a trend improvement in conditions in manufacturing, construction, wholesaling, finance and transport.

More broadly, these figures present clear upside risks to our current GDP forecasts for flat to slightly negative growth through the second half of 2009, and suggest that we may now have seen the low for the RBA cash rate in the current cycle.

Our economic forecasts are predicated on three key drivers: (1) falling business investment in response to lower corporate profits, economic uncertainty and reduced capacity utilisation – a gap which cannot be fully plugged by rising government investment; (2) falling exports in line with weak demand amongst our major trading partners; and (3) soft household consumption growth, particularly as the impact of cash handouts, tax cuts and lower interest rates starts to wane and unemployment rises.

The improvement across measures of business confidence and conditions in recent months however suggests firms may not cut back as fervently on investment expenditure as we have been anticipating. The marked pick-up in Chinese GDP and industrial production reported today also suggests that China will now achieve its growth target of 8% in 2009. This may result in a more positive prognosis for investment in the mining sector, particularly if it results in higher commodity prices, and for Australian exports.

The same goes for labour costs, with NAB’s measure of employment experiencing its largest monthly gain ever to rise 18 points to -7. This is the first clear sign of improvement in any of the surveys of labour demand. If these trends continue, it is possible that we may avoid substantial falls in employment in the Australian context. It is important to note however that even if employment does not fall, unemployment will rise due to strong growth in the labour force (driven by strong population growth and high participation rates). On our calculations, the unemployment rate would still rise to 6.2% by end-2009 and to 6.7% by mid 2010 if employment remained steady, up from 5.8% now.

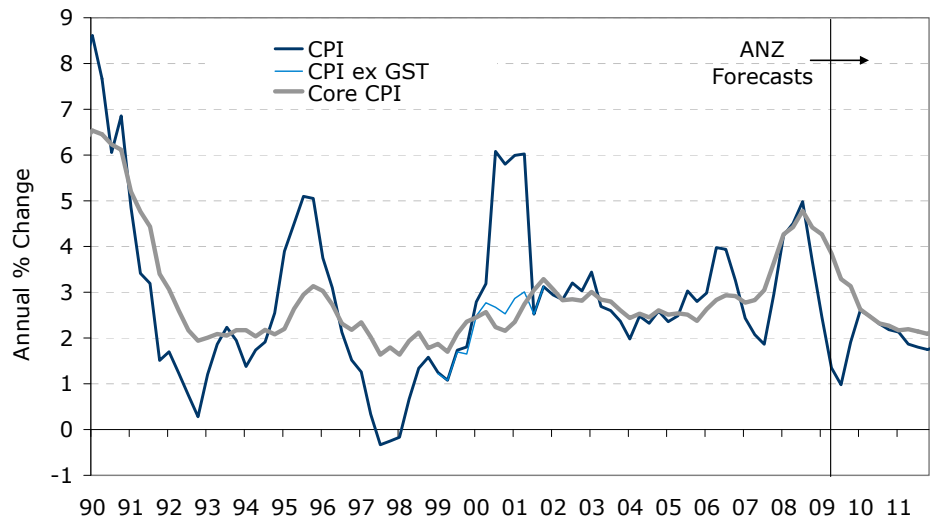
### Inflation to remain subdued in Q2

Despite more “greenshoots” in the economic activity data, there was little evidence of inflationary pressures in the NAB survey data. Capacity utilisation remained low at 79.3% in June, down almost 5ppt from its peak of 84.2% in

April 2008. Measures of prices and costs were also subdued; purchase costs, labour costs and selling prices have either been flat on average in the past three months or slightly negative.

This is consistent with our expectations for next week's official inflation data for Q2. ANZ is forecasting a gradual deceleration in inflation, with headline inflation to ease to 0.4% QoQ and 1.3% YoY and core inflation to slow to 0.7% QoQ and 3.9% YoY (see Figure 2 below). This subdued inflation forecast is largely due to expectations that price rises for most components will be fairly subdued amidst softer demand conditions (albeit stronger than we may have expected) and low rates of capacity utilisation. The exchange rate impact is also likely to be relatively muted, with any residual impact from the sharp currency depreciation in late 2008 offset by the re-appreciation from February 2009 onwards.

**Figure 2: The CPI outlook**



Source: Bloomberg and ANZ.

Looking at the detail, the main upside drivers of headline inflation are expected to be: petrol prices (with the impact of higher global crude oil prices partly offset by the stronger AUD); health services (due to the annual rise in health insurance premiums); rents (although this is likely to be weaker than in previous quarters); and house purchase costs. Clothing and footwear prices are also expected to increase due to a seasonal reduction in discounting in the June quarter; the early start to winter sales may suggest this rise could be smaller than in previous years, although the impact of the earlier exchange rate depreciation and solid demand from cash handouts poses equal upside risk. These drivers will be partly offset by lower food prices, due to the usual seasonal fall in fruit and vegetable prices and a fall in airline fees due to increased competition.

#### Data wrap

- **Lending finance data** showed a 2.9% fall in personal finance commitments in May, while commercial finance approvals improved by 4.0%.
- The **NAB Monthly Business Survey** reported a significant improvement in business conditions and business confidence (see above).
- The **Westpac Leading Index** fell by 0.2% in May after rising 0.5% in June. The annualised pace of growth, which aims to lead economic activity 3 to 9 months in the future, improved slightly to -3.9% from -4.1% in April and a low of -6.1% in February.

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## Interest Rate Markets: The correction falters

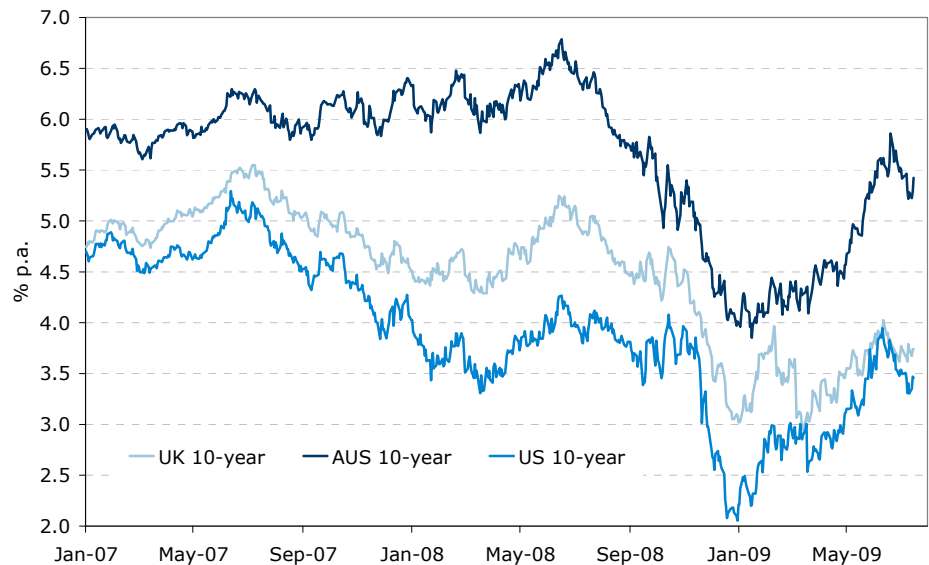
- The recent fall in market rates was limited and short-lived. Strong domestic data, unexpected strong inflation data and possible signs that extra-ordinary policy measures are being unwound have put a floor under market rates. Risk is now for a sustained move higher.
- Recent data has highlighted the extent to which Australia is outperforming. As rate cut expectations have been unwound, there has been a significant flattening of the domestic yield curve over the past 5 weeks.

### Unwinding

Market interest rates had moved lower in recent weeks. But this now appears to have come to an end. Concerns over the strength of the global recovery have been overtaken by a relatively strong start to the US Q2 reporting season and some better US activity data. Locally, a strong rebound for the NAB business survey has impacted expectations about the scope for rate cuts here in coming months.

In the US, the safe-haven bid for bonds has been undermined this week by better than expected earnings results for Q2 and on the back of stronger than expected industrial production and retail sales data (although underlying demand remains a concern). Supply concerns also rose after the US Government reported a record deficit for June at more than \$US94bn. The 9-month financial year-to-date deficit now stands at more than \$US1.08 trn. US 10-year bond yields are back near 3.50% having fallen by almost 75bps in recent weeks toward 3.25%.

**Figure 3: 10-year bond yields**



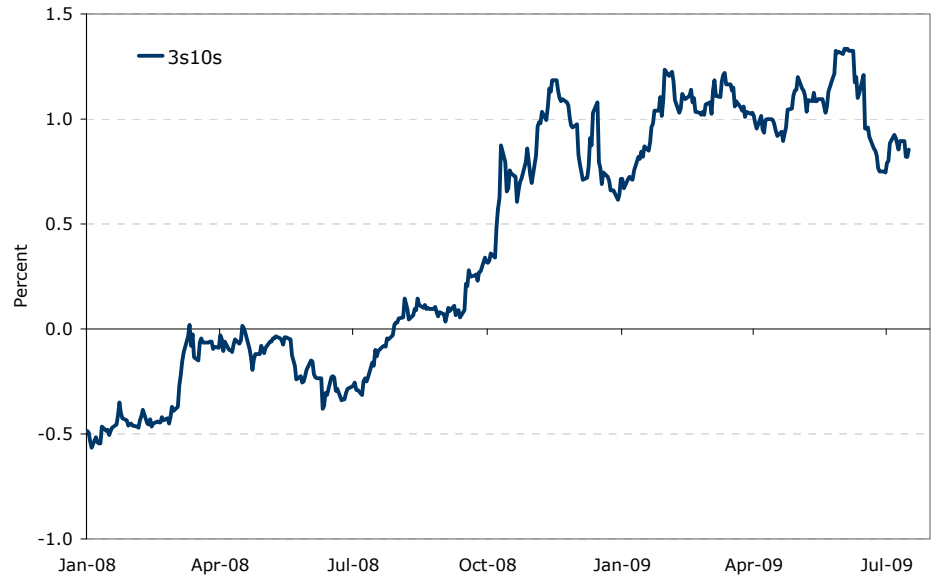
Source: Bloomberg

The Bank of England also surprised the market by not extending bond purchases as part of the quantitative easing policy beyond the end of August. This saw UK 10-year bond yields rise by 18bps in response to the news. Deputy Governor Bean mentioned overnight that the Bank risks higher inflation if they wait to exit QE for too long. The Bank will clarify the policy outlook when the BoE's Monetary Policy Committee meets again to consider policy options on August 6.

Locally, yields on Australian 2-year swaps had fallen by over 50bps in the past month, before rising again by around 20bps over the course of this week. Market pricing at the front-end suggests there is now little scope for the RBA to ease rates in coming months. Only a 25% chance is now factored in, with over 125bp of rate hikes expected over the course of 2010.

Another impact of stronger domestic data (see page 2) has been a significant flattening of the shape of the yield curve as rate cut expectations have been unwound. The spread between 3 and 10-year yields is back near 80 bps having traded near 140bps at the beginning of June.

**Figure 3: Australian 3s10s curve**



Source: Bloomberg

We agree that the risk is now clearly that the RBA cash rate has troughed in the current cycle. However, this week's strong data does not mean that rate hikes are imminent in our view. Despite the upside risks to our economic forecasts, economic recovery is still expected to be very slow and protracted. In addition, better than expected growth outcomes will not be enough to prevent rising unemployment (see above). It would be unusual for the RBA to be raising interest rates while unemployment is still rising. As such, we believe market pricing for rate hikes through 2010 is overdone.

We will get some important insights into RBA thinking over the next few weeks. The RBA is likely to upgrade forecasts in the Statement of Monetary Policy released on 7<sup>th</sup> August. RBA Governor Stevens speaks on 28<sup>th</sup> July and the RBA board meets on 4<sup>th</sup> August. If the market still sees some scope for the RBA to ease rates later in the year, we will need to see a weak inflation pulse in Q2 data due out next week.

Without some clear disappointments in the US Q2 reporting season, local market yields look set to remain under upward pressure in the near-term.

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## FX: Risk on - AUD/USD flirting with 0.80

### Recommendation

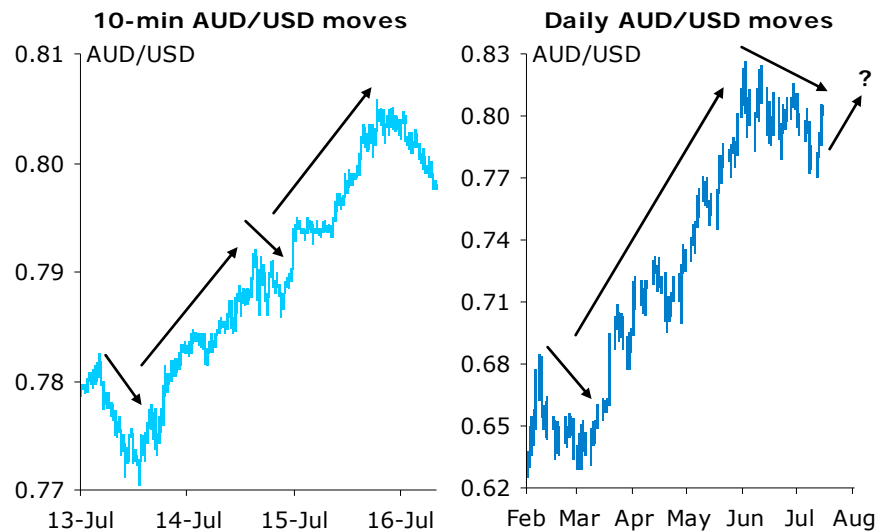
Range trading is likely to remain the persistent theme in AUD trading next week. AUD sellers should look to spikes above AUD/USD 0.8050, while AUD buyers may wish to pounce on moves below 0.7860. The US corporate reporting season, which has already got off to a positive start, remains the key risk to the AUD's fortunes over the coming week. Australian Q2 CPI due next Wednesday is not expected to provide much stimulus for the AUD to move out of recent ranges.

### AUD/USD moves toward upper bound of recent range

AUD remains stuck in a broad trading range against most major currency crosses. This is in line with other financial indicators, with equity and commodity markets also maintaining recent broad trading ranges. The consolidation in markets is unsurprising, given the big moves over May and June. Markets now appear to be in a wait and see mode, searching for the next big theme to drive new meaningful direction, and volatility remains relatively subdued. Even today's Chinese Q2 GDP release was a case of 'buy the rumour, sell the fact,' with AUD/USD failing to find support on the better than expected result and dipping back below 0.80.

An assessment of technical rather than fundamental studies suggests a possible upside move in AUD/USD over the coming week. The chart below suggests that following the March – June rally in AUD/USD, the June – July period of consolidation could preface a further push higher. Initially we look for AUD/USD to retest June's high around 0.8150.

**Figure 1: Technicals suggest AUD/USD may map this week's move higher**



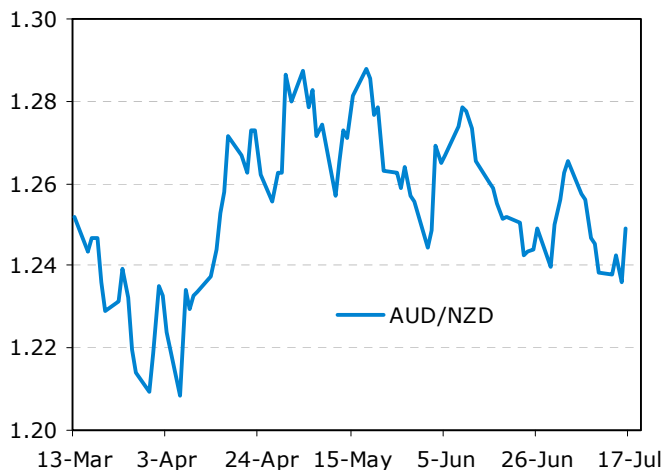
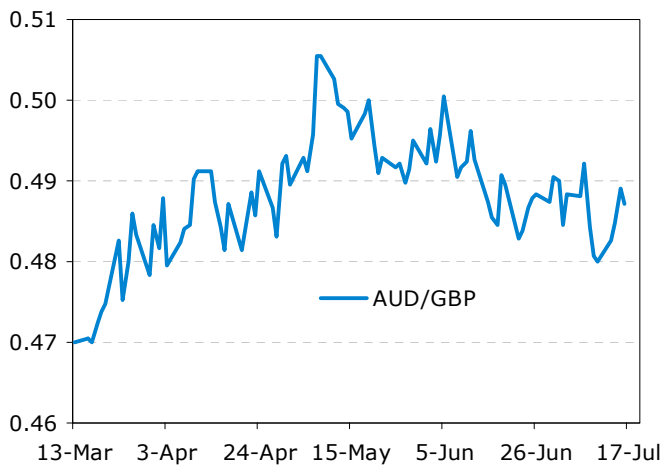
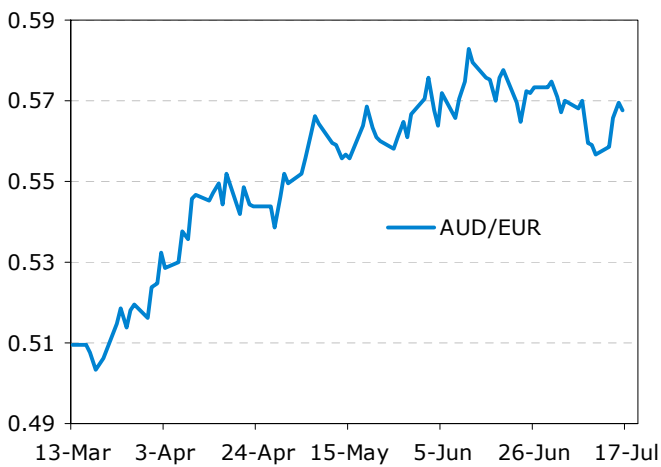
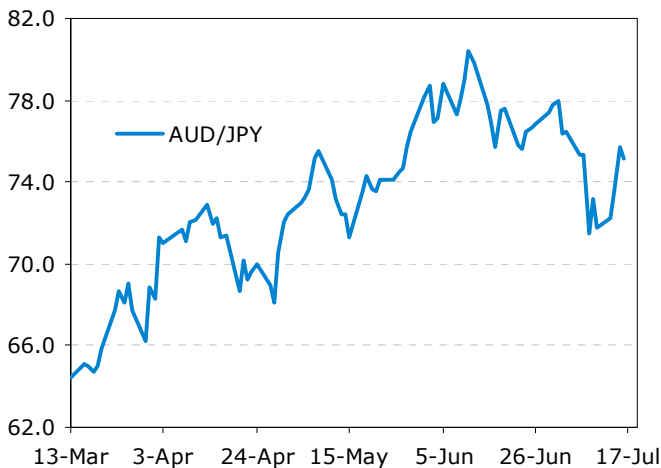
Source: ANZ, Bloomberg

For now, expect the US earnings season to continue to dominate direction, both for short-term moves and likely direction for the rest of Q3. We have been expecting a disappointing profit season to spark a reversal in risk appetite and an increase in safe-haven flows. But so far, so good, with earnings surprising on the upside. If this continues, the risk is for the USD to re-weaken. Already at a one-month low, if the DXY heads back towards 75, this will provide one of the biggest upside challenges to our forecast for the AUD/USD to ease below 0.75.

Next week's inflation data are unlikely to provide much impetus for the AUD to break out of recent ranges. While the AUD would likely spike higher on signs that the CPI is accelerating, this seems unlikely given the June CPI tends to be seasonally low (see *Macroeconomic Update*). We doubt a weaker than expected inflation read would be sufficient to sustain more than an initial dip lower in AUD/USD for without some bad labour market data, markets are still likely to remain unconvinced the RBA will cut rates again before year-end.

**AUD/USD Key levels: 0.7860 – 0.8150.** A hold above 0.8050 opens the door for a meaningful move towards 0.8150. On the downside, disappointing Q2 US corporate reports could see a retest of 0.7860

## AUD cross view



### AUD/JPY Key levels: 71.00 – 76.50

- A reversal in risk appetite this week has seen JPY sold-off in favour of AUD and the cross regaining last week's losses. Briefly spiking above last week's suggested topside level to AUD/JPY76, the cross has since consolidated back around 75. A continuation of this more buoyant theme on the back of further positive US corporate sales results could see the cross push higher to test 76.5.
- Japanese merchandise trade data for June due for release next week will likely have little impact on AUD/JPY unless exports (in particular) show a significant improvement or deterioration from May's result.

### AUD/EUR Key levels: 0.5580 – 0.5750

- Following three solid attempts, AUD/EUR broke below last week's downside target of 0.558, but the subsequent recovery in market sentiment has since seen the cross push comfortably above 0.5650. That said, the cross's rally from a 2009 low around 0.49 continues to lose momentum, the 50-day moving average steadying to 0.5670.
- Beware of next week's release of July Purchasing Managers' Indices in the Euro zone – a pull back in the data, especially in the manufacturing series, will likely weigh on EUR/USD, although AUD/EUR is expected to remain rooted in its tight trading range of 0.5550-0.5750 of the past three weeks.

### AUD/GBP Key levels: 0.4780 – 0.4920

- AUD has outperformed GBP this week as better than expected US corporate announcements boosted risk appetite, with the cross briefly trading above 0.49. AUD/GBP is now just above its 100-day moving average of 0.4850.
- A busy week for data in the UK. The market will keenly anticipate the Q2 GDP release, with house price and retail sales numbers also due out of lesser interest. Better than expected reads could see GBP/USD push up towards 1.6550 for a potential retest of this year's high of around 1.6740. This could see AUD/GBP trade heavily and possibly move back towards 0.4780.

### AUD/NZD Key levels: 1.2350 - 1.2660

- We saw strong support at last week's downside key level of AUD/NZD1.2350, despite attempts to break lower on three separate days. A successful move south could see the cross push toward 1.2210. However, an extension of today's spike towards 1.25 on a cut in NZ's long-term sovereign outlook could see the cross rise to 1.2660.
- The US corporate reporting round will likely dictate AUD/NZD moves this week. As has been the case in recent sessions, NZD could outperform AUD and see AUD/USD retest the 1.2350 level yet again, although a stronger than expected Australian CPI read could push AUD/NZD higher towards 1.2660.

## ANZ economic and financial market forecasts

Australian economic indicators	2007	2008	2009f	2010f
<b>Economic activity (annual % change)</b>				
Private final demand	4.1	-1.9	-0.8	3.3
Household consumption	2.2	1.0	1.2	2.9
Dwelling investment	2.5	-6.8	8.4	10.3
Business investment	13.8	-9.6	-11.6	1.9
Public demand	5.3	2.0	6.6	4.1
Domestic final demand	4.4	-1.1	0.9	3.5
Inventories (contribution to GDP)	-0.6	-0.2	0.3	0.1
Gross National Expenditure (GNE)	3.8	-1.2	1.1	3.6
Exports	3.9	-1.9	-3.5	4.2
Imports	10.3	-11.7	1.1	7.7
Net Exports (contribution to GDP)	-1.5	2.5	-1.0	-0.9
<b>Gross Domestic Product (GDP)</b>	<b>2.3</b>	<b>0.0</b>	<b>0.6</b>	<b>3.1</b>
<b>Prices and wages (annual % change)</b>				
Inflation: Headline CPI	4.4	1.7	2.4	1.8
Underlying*	4.5	3.6	2.4	2.1
Wages	4.3	3.6	2.9	3.2
<b>Labour market</b>				
Employment (annual % change)	2.2	-0.3	-0.8	2.0
Unemployment rate (%)	4.3	6.1	7.9	7.6
<b>External sector</b>				
Current account balance: A\$ bn	-51.0	-42.6	-65.5	-73.0
% of GDP	-4.3	-3.6	-5.4	-5.6

\*Average of RBA weighted median and trimmed mean statistical measures.

Australian interest rates	Current	Sep 09f	Dec 09f	Mar 10f	Jun 10f	Sep 10f
RBA cash rate	3.00	3.00	2.50	2.50	2.50	2.50
90 day bill	3.14	2.90	2.75	2.75	2.80	3.00
3 year bond	4.50	4.05	4.05	4.15	4.20	4.60
10 year bond	5.48	5.35	5.25	5.25	5.20	5.45
3s10s yield curve	0.98	1.30	1.20	1.10	1.00	0.85
3 year swap	4.75	4.35	4.35	4.45	4.50	5.07
10 year swap	5.93	5.75	5.60	5.55	5.50	6.00
<b>International interest rates</b>						
RBNZ cash rate	2.50	2.50	2.50	2.50	2.50	2.50
NZ 90 day bill	2.80	2.80	2.80	2.80	2.80	2.80
US Fed funds note	0.25	0.25	0.25	0.25	0.25	0.50
US 2 year note	0.97	1.10	1.00	1.25	1.50	2.00
US 10 year note	3.56	4.25	4.00	4.15	4.30	4.50
Japan call rate	0.10	0.10	0.10	0.10	0.10	0.25
ECB refinance rate	1.00	0.75	0.75	0.75	0.75	1.00
UK repo rate	0.50	0.50	0.50	0.50	0.50	0.50

For additional information on interest rates please refer to ANZ's *Interest Rate Strategy Weekly*.

Foreign exchange rates	Current	Sep 09f	Dec 09f	Mar 10f	Jun 10f	Sep 10f
<b>Australia and NZ exchange rates</b>						
A\$/US\$	0.80	0.76	0.73	0.74	0.76	0.78
NZ\$/US\$	0.64	0.58	0.55	0.54	0.54	0.55
A\$/¥	74.95	74.48	73.00	77.70	82.08	85.80
A\$/€	0.57	0.56	0.56	0.57	0.58	0.59
A\$/£	0.49	0.48	0.46	0.46	0.48	0.48
A\$/NZ\$	1.25	1.31	1.33	1.37	1.41	1.42
A\$/CA\$	0.89	0.87	0.88	0.87	0.87	0.90
A\$/CHF	0.86	0.85	0.83	0.84	0.85	0.87
A\$/CNY	5.46	5.19	4.99	5.05	5.19	5.32
A\$ Trade weighted index	63.80	62.29	59.98	61.22	63.25	64.28
<b>International cross rates</b>						
US\$/¥	93.9	98.0	100.0	105.0	108.0	110.0
€/US\$	1.41	1.35	1.30	1.30	1.31	1.32
€/¥	132	132	130	137	141	145.20
£/US\$	1.64	1.59	1.58	1.60	1.60	1.62
€/£	0.86	0.85	0.82	0.81	0.82	0.81
US\$/CA\$	1.12	1.15	1.20	1.18	1.15	1.15
US\$/CHF	1.08	1.12	1.14	1.14	1.12	1.12
US\$ index	79.5	82.5	85.0	85.2	84.9	84.60
<b>Asia exchange rates</b>						
US\$/CNY	6.83	6.83	6.83	6.83	6.83	6.82
US\$/HKD	7.75	7.75	7.75	7.75	7.76	7.77
US\$/IDR	10088	10250	9750	9500	10000	9500
US\$/INR	48.63	48.50	48.00	47.00	47.50	47.00
US\$/KRW	1267	1225	1125	1175	1225	1100
US\$/MYR	3.57	3.60	3.55	3.50	3.50	3.45
US\$/PHP	48.03	49.00	48.00	48.00	47.00	47.00
US\$/SGD	1.45	1.52	1.51	1.50	1.50	1.49
US\$/THB	34.06	36.00	35.50	35.00	35.00	34.50
US\$/TWD	32.93	32.50	32.00	31.50	31.00	30.30
US\$/VND	17801	18500	18500	18500	18500	18500
<b>Pacific exchange rates</b>						
PGK/US\$	0.386	0.350	0.350	0.350	0.360	0.360
FJD/US\$	0.487	0.464	0.450	0.450	0.454	0.460

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